

**SUPPLEMENTAL (AND MINORITY) REPORT
BY CERTAIN MEMBERS OF THE
MISSOURI TAX CREDIT REVIEW COMMISSION**

(December 12, 2012)

**Supplemental (and Minority) Report by Certain Members
of the
Missouri Tax Credit Review Commission**

Introduction and Background

On July 21, 2010, Governor Jay Nixon created the Missouri Tax Credit Review Commission and charged it with the responsibility of reviewing Missouri's various Tax Credit Programs. The Governor asked the Commission to make recommendations to both the Governor and Missouri's General Assembly concerning how Missouri's numerous tax credit programs should be changed. The changes recommended by the Commission were supposed to focus on ways these programs might achieve greater efficiency and provide a positive return on Missouri's investment in these programs. Governor Nixon named twenty-seven (27) business, community, and legislative leaders to serve on the Commission. Between the date of the Governor's call and November 30, 2010, the Tax Credit Review Commission met, established ground rules and principles, and prepared an extensive report. That report summarized the Commission's consensus as to which of Missouri's numerous Tax Credit Programs should be continued, modified, or terminated. Unfortunately, neither the 2011 nor 2012 legislative sessions resulted in any reform of Missouri's tax credits.

On September 12, 2012, Governor Nixon asked the Tax Credit Review Commission to review its 2010 recommendations and to determine the extent to which any of those recommendations should be supplemented, amended, or rescinded. Pursuant to that call, the Tax Credit Review Commission convened, held committee meetings, reviewed the various reports prepared by it in 2010, and solicited public input.

The impetus for the Governor's 2012 request of the Tax Credit Review Commission is the steadily increasing portion of the State's budget which Tax Credits consume. For the State's fiscal year ending in 2012, the State will have total expenditures of \$8,640,000,000. Of those total expenditures, tax credits will consume more than \$629,000,000.

Because of the limitations imposed by the "Hancock Amendment," and the difficult economic times that the State of Missouri has faced since calendar year 2008, the Governor and General Assembly had to curtail or reduce several important public benefits. Much of the State's budget is nondiscretionary, i.e., it consists of expenditures which, as a practical matter, cannot be materially affected or modified. These "fixed" expenditures inevitably will increase over time. With that increase must come a corresponding reduction in the "discretionary" component of the State's budget. Some believe the State's tax revenues have not kept pace with budgetary needs. Others believe that Missouri's present income tax structure is adequate. Had the State infinite revenues, a discussion of the State's various Tax credit programs might have a different focus. However, that is not the case. Instead, the annual increase in the total amount of redeemed tax credits now forces the Legislative and Executive branches of Missouri government to confront unpleasant choices between

the lesser of two evils, i.e., either reduce Tax credit programs, or reduce the State's support of such important public programs as education, medical care, highways, etc. Missouri's General Assembly has debated the extent to which any "fat" remains in the State's budget that can be eliminated. However, it is clear to all concerned that any budgetary decision involves difficult, occasionally unpleasant, and limited choices.

State employees and elected representatives have a sworn and clear responsibility to the citizens of Missouri to verify that each of the State's expenditures are constitutional, worthy of the priority assigned to them, and funded only to the extent reasonably necessary. Each of the State's tax credit programs, regardless of their relative contribution towards the State's fiscal problems, must be evaluated for efficiency, fairness, cost, and benefit to the State of Missouri.

The State Tax Credit Review Commission met and following its last meeting on December 7, 2012, prepared a supplemental report to the Governor. Much of that report reiterates the substance and recommendations of the Commission's 2010 report. However, in certain key respects, the 2012 report differs from the 2010 report, and modifies certain important recommendations made in the 2010 report. Those departures from the 2010 report have prompted the signatories to this Supplemental (Minority) Report to ask that the Executive and Legislative branches of Missouri government to consider this Minority Report in addition to the Commission's Supplemental Report during the legislative session commencing in January 2013.

Objections to Modifications to 2010 Report in the 2012 Report

The below named members of the Commission believe that the Commission's 2012 Report should not have:

- recommended that the proposed ceiling or annual “cap” on Historic Rehabilitation Tax Credits be increased to \$90 Million instead of the \$75 Million ceiling recommended in the 2010 Report;
- recommended that annual ceilings or “caps” with respect to the Low Income Housing Tax Credit be expressed by reference to a credit which is claimed over ten (10) years instead of five (5) years; and
- withdrawn the Commission's 2010 recommendation that all tax credits be subject to a mandatory review process which involves “sun setting” i.e., which imposes on all tax credit programs the requirement that, after being in effect for a specified number of years, each such credit expire unless it is expressly authorized for renewal and extension by the General Assembly.

All three of these departures from the Commission's 2010 report the undersigned Commissioners believe are unwarranted departures from the Commission's 2012 charge from the Governor and are contrary to the best interests of the State of Missouri.

Discussion of Relevant Principles and Concerns

To assist the Legislative and Executive branches, the signatories to this Minority Report ask that the following be considered in the context of legislation proposed in response to the Commission's report, to-wit:

A. **Tax Credits are a Grant of Public Money or Property:** The Missouri Supreme Court in the case of Curchin v. Missouri Industrial Development Board, 722 SW2d 930 (Mo. 1987) stated that:

"A tax credit is as much a grant of public money or property and is as much a drain on the State's coffers as would be an outright payment by the State."

However, tax credits and direct appropriations differ with respect to a taxpayer's standing to challenge them.² As a result of the 2011 Missouri Supreme Court opinion in Manzara, et al. v. State of Missouri, et al.,³ a taxpayer does not have standing to challenge the validity of a tax credit unless the taxpayer can show some direct and particular connection to it. Accordingly, a Missouri citizen cannot challenge the award of a tax credit merely because that citizen is a taxpayer.

B. **Constitutional Duty of Legislature:** Section 38(a) and Section 39 of Article III of the Missouri Constitution prohibit the granting of public money or property for the benefit of any private person, association, or corporation. Those Sections also prohibit the Legislature from giving or lending the credit of the State in aid of any person, association, or corporation. Finally, those Sections prohibit the legislature from pledging the credit of the State towards the payment of the liabilities of any individual, association, or corporation.⁴ Missouri's officials must not allow

¹ 722 SW2d at page 933.

² See, e.g., Manzara, et al. v. State of Missouri, et al., 343 SW3d 656 (Mo. Banc 2011); Arizona Christian School Tuition Organization v. Winn, 131 S.Ct. 1436, 1440 (2011)

³ Manzara, supra.

⁴ Section 38(a) of Article III of the Missouri Constitution reads as follows:
The general assembly shall have no power to grant public money or property, or lend or authorize the lending of public credit, to any private person, association or corporation, excepting aid in public calamity, and general laws providing for pensions for the blind, for old age assistance, for aid to dependent or crippled children or the blind, for direct relief, for adjusted compensation, bonus or rehabilitation for discharged members of the armed services of the United States who were bona fide residents of this state during their service, and for the rehabilitation of other persons. Money or property may also be received from the United States and be redistributed together with public money of this state for any public purpose designated by the United States.

Section 39 of Article III of the Missouri Constitution states, in pertinent part, as follows:

The general assembly shall not have power:

(1) To give or lend or to authorize the giving or lending of the credit of the state in aid or to any person, association, municipal, or other corporation;

Missouri's tax revenue to be used in a way which violates either the spirit and letter of Sections 38 and 39 of Article III of Missouri's Constitution. Because of legal challenges to tax credits by taxpayers are virtually impossible, it is only the discretion, judgment, wisdom, and conscience of the Legislative and Executive branches that will prevent tax credits from being utilized in an unconstitutional manner.

C. **Criticisms of Tax Credits and Government Intervention in Economic Activity:** In recent years, government intervention in the marketplace and attempts to target specific industries for benefit have come under substantial and well-reasoned criticism. Indeed, some of this criticism has existed for many years, and has been ignored.⁵ The desire to do something in response to public adversity is, perhaps, a noble and understandable instinct held by most public servants. However, doing "something" which does not have a demonstrable and proven public benefit cannot be justified on economic grounds. Conferring a special benefit upon friends of those in power is much more damaging to the state than doing nothing. Accordingly, in the context of a consideration of each of the tax credit programs recommended for modification (or termination), the signatories to this Minority report believe the following principles and considerations are important:

1. **Tax Credit Programs Must be Justifiable as Fundamentally Beneficial and Provide a Reasonable Return on Investment to the Public and the State as a Whole:** There can be no doubt that tremendous wealth for a few favored businesses and persons has been conferred by the State of Missouri as a result of its tax credit programs. Whether those individual benefits are continued must depend upon whether Missouri, in fact, benefits from that continuation.

"Tax credits are preferences in the Tax Code that aim to induce some type of economic activity that would not have occurred—or would have occurred to a lesser degree—without the credits. Championed by some and vilified by others, these types of incentives have been widely embraced as an economic development tool by state governments in New England and across the Country.

Tax Credits allow businesses to reduce their tax liability dollar for dollar based on the amount of desired activity they undertake. Although tax credits usually do not require state governments to make cash outlays, they can represent foregone revenue. And because most states must balance their budgets, they must "pay for" in the expected revenue losses stemming from the credits by increasing other taxes or reducing spending.

Whether state business tax credits actually spur new economic activity—and whether they do so in a cost effective manner – are important concerns. This is particularly

(2) To pledge the credit of the state for the payment of the liabilities, present or prospective, of any individual association, municipal or other corporation.

⁵ See, e.g., Hazlitt, *Economics in One Lesson*, Pocketbooks (1948); Frederick A. Hayek, *Road to Serfdom* (Chicago: University of Chicago Press, 1944).

true in times of fiscal and economic stress, when policy makers must balance a desire to spark the economy with the need to cope with budget deficits. Unfortunately, determining a tax credit's costs and benefits is inherently difficult—partly because it is impossible to know the level and mix of economic activity that would occur without the tax credit."⁶ (emphasis added)

Missouri prides itself as being the "Show-Me State." This appellation stems from the justifiable skepticism with which Missourians have viewed popular fads. This same historical Missouri pragmatism, demand for a clear demonstration of cause and effect, and verification of public benefits is needed now in considering whether any of Missouri's tax credit programs should be allowed to continue.

2. Government Dollars are Not "Magic": Expenditures by state, federal, and local governments to encourage economic activities frequently are justified on the theory that those dollars have a "multiplier effect." This, charitably, is extremely difficult either to prove or to understand. In other words, the theory advanced is that a dollar spent by an ordinary citizen will not have exactly the same "stimulus" effect as would a dollar spent by the State. When the State takes a dollar from a citizen and spends it, it is, in reality, a "zero sum game." The dollar the State chooses to spend in a certain manner is but the same dollar the citizen would have spent in another manner. The invisible, but nevertheless clearly adverse result from the State taxing a dollar away from the citizen and then spending it on a favored state project is the loss of the beneficial effects on the economy which would have occurred if the State had left the citizen with his or her dollar in the first place.⁷ Thus a positive "multiplier" applied to a state expenditure is always balanced by a negative "multiplier" which must be attributed to the taxpayer's lost dollar.

In short, when it comes to tax credit programs, any justification of a program based upon its supposed salutary effect on the economy is specious if all the program succeeds in doing is spending money somewhere within Missouri's borders. Instead, a tax credit program's continuation must be analyzed as if it were a direct appropriation of state funds, and the questions must be: does the program cause Missouri to benefit to the same extent that it incurs the cost involved? Does the tax credit program fund a pressing public need in a more efficient manner than if a direct appropriation to meet that need were involved? Are the costs to Missouri the same costs anyone would incur in purchasing the product or service involved? A benefit to an individual or enterprise is not the same thing as a benefit to the state as a whole. An improvement to a building which is owned by a private individual but which is paid for with public tax dollars is very difficult to justify as being a benefit to the state; instead, when public monies are applied to a purely private benefit (which is the case for many of Missouri's tax credit programs) it is a misappropriation of public funds.

⁶ Weiner, State Business Tax Incentives "Examining Evidence of Their Effectiveness," New England Public Policy Center discussion paper 09-3 (December 2009) page 1.

⁷ Hazlitt, *Economics in One Lesson*, Pocketbooks (1948).

3. It is a Strange Time in Our Nation's History: Economists, with a perfectly straight face, will declare that government dollars spent with respect to "stimulus programs" have a positive effect on the economy, but collecting taxes to pay for those stimulus programs will have a profoundly negative effect (such as is presently threatened upon the expiration of the Bush-era 2001 tax cuts now scheduled to expire on December 31, 2012). Economists seem to be saying that the tax dollars collected by the government and spent by the government, in turn, will have a negative effect, but if the government borrows money and spends it, that has a positive effect. That reasoning only makes sense if you believe you will die before the Piper must be paid.

Perhaps, in a macro-economic sense, these contradictory positions are true on the national level. Whether it is true or is nonsense is an issue for Congress to resolve, however, and is not a model Missouri can imitate. The State of Missouri must balance its budget each year, and cannot engage in deficit financing for stimulus purposes. The State of Missouri can't use borrowed funds for stimulus purposes—it has to use collected tax dollars. Accordingly, any expenditure intended to stimulate the economy must have a proven and demonstrable positive effect on the State's economy, or it should not be funded—whether through a direct appropriation or tax credit.⁸

A convincing argument may be made that some programs which will encourage the creation of new and permanent jobs can be justified on the basis of the overall improvement to the economy that a stable and increasing employment condition brings. However, tax credit programs which only serve to induce the marketplace to construct one type of building instead of another, to create one type of tangible asset instead of another, or to benefit one competitor in an economic marketplace when a corresponding benefit is not granted to another must be viewed with a great deal of skepticism.

Certainly it is possible to take large quantities of public funds, invest them heavily in a concentrated manner within one community, and see improved economic conditions in that community as a result. But that involves a deliberate preference on the part of the government for one community over another, for one group of taxpayers in preference to many others, and for one particular economic activity over many others. The use of public funds to favor a narrow and particular class of taxpayers over others similarly situated is a dangerous and suspect course of action. It is not that readily observable benefits are not created; it is that merely creating economically beneficial activity for a small group of people by forcing others to sacrifice is, in every sense, a violation of Sections 38 and 39 of Article III of the Missouri Constitution. Without an overall and clear benefit to the public as a whole, it should not be considered.

4. Excessive Costs: Distinct from the question of whether tax credit programs create demonstrable economic benefits is the question of whether some tax credit programs cause the State to spend excessive money to achieve the desired benefit—amounts far greater than a discriminating

⁸ *An Assessment of the Effectiveness and Fiscal Impacts of the Use of Local Development Incentives in the St. Louis Region*, Interim Report, East-West Gateway Council of Governments, January 2009; Peters and Fisher, *The Failures of Economic Development Incentives*, Journal of the American Planning Association, Volume 70, No. 1, Winter 2004.

consumer otherwise would spend under the same circumstances. Therefore Missouri needs to determine whether a tax credit program causes it to incur an expense which does not equal (let alone exceed) the value of the benefit.

For example: assume that shelters for abused women require television sets. Instead of procuring those television sets in the open market based on competitive bids, however, a favorable contract for furnishing those television sets is awarded to an influential and politically powerful business person who sells those television sets, to the shelters at a substantially marked up price. Those television sets which might otherwise cost a discriminating consumer \$300.00 each, instead cost the State \$1,000.00 each. Confronted with this disparity in cost, those who advocate for the program in question do so on the theory that the money spent creates a "multiplier effect" which "stimulates" the State's economy, as well as the fact that the television sets now benefit a worthy group of needful citizens. Ignored in this rebuttal is the undeniable fact that a waste of public money has occurred— a waste which cannot be justified on the theory that it has gone for a "good cause." The public is not that foolish. The public realizes that what should have cost \$300.00 instead cost \$1,000.00 so that a favored pressure group or constituent might enjoy a substantial private benefit at public expense.

The Low-Income Housing Tax Credit is an example of a distortion in costs and benefit. That Missouri needs affordable housing is not in dispute. But spending excessively on one project where two might have been built with the same funds is not justifiable. A low-income housing tax credit, as presently structured, must be redeemed over a period of 10 years. As a result, this tax credit must be "sold" by the developer to whom it is awarded for less than 40% of the eventual cost to Missouri. Put another way, Missouri intends that the developer of a low-income housing project benefit from the credit so that a new housing project will result. But the current benefit to the developer of a Low-Income Housing Tax Credit project is only about forty cents of One Dollar (\$1.00) of credit awarded, and thus less than forty cents (\$0.40) is actually invested in the project itself. The remaining sixty cents (\$0.60) is then absorbed in the process of marketing the tax credits to third party investors who redeem the credits against their taxes otherwise due. In effect, the state has borrowed forty cents over a period of ten years, but must make payments on that debt at the rate of ten cents per year over that term. That is a rate of interest of more than 21% per annum. The state is borrowing money in connection with this tax credit program at a rate higher than that charged to the most risky of borrowers at a time when Missouri's credit rating is among the highest of all the states. This should be a source of great embarrassment to Missouri.

Yes, the State perhaps has assured itself of another Low-Income Housing Tax project because of this tax credit. However, the State's cost in achieving that benefit must be closer to the actual value of the credit to the developer. No serious effort has been undertaken to analyze the "leakage" under this program until now. The cost of this tax credit must be aligned with the cost of the construction of these projects. In fact, each of the tax credits now authorized by Missouri law should be evaluated as though Missouri were borrowing the funds actually invested in the benefit and paying back that loan with the amounts for which the credit can be redeemed. If the effective rate of interest being paid by Missouri for a credit under this analysis exceeds what Missouri would pay pursuant to State bonds, then the conclusion that public funds are being wasted seems inescapable.

5. Assisting One Business at the Expense of Other Businesses: It is true that Missouri is in competition with other states for new businesses. Astute and sophisticated businesses shopping for new locations have learned that they can leverage one state against another in an effort to obtain favorable tax and economic benefits. Insofar as the states themselves are concerned, it is but another example of a "zero sum game." One state's gain is another's loss. Nevertheless, until some national effort is made to curtail this form of competition, the practice is certain to continue. It will be very difficult for Missouri to abandon these incentives when they are obviously successful, and a failure to offer them might result in businesses relocating outside the state.

Accordingly, the undersigned recognize that the competition between states for favored industries is likely to continue. Having acknowledged that fact, however, does not justify ignoring the impact that recruiting a new business will have on a like business already operating within the State. In fact, that should be the first analysis, to-wit: will the recruiting and solicitation of a new business with favored tax incentives place an existing Missouri business in a position of being at a competitive disadvantage? If there is any reasonable possibility of this fundamental unfairness being the result, then the recruitment of the new business should not be permitted. Alternatively, if the new business is to receive a favored tax benefit, then all other businesses already in the State of Missouri and in a similar economic activity should be equally favored. Otherwise it would be tantamount to the State picking winners and losers. Directed capitalism is not something that Missouri's tax credit system should encourage or into which it should degenerate.

With the Historic Rehabilitation program, this principle is ignored in the context of granting to certain favored real estate developers economic advantages not offered to competitors for the same tenants in the same vicinity. This is but another reason why the 2010 Commission recommendation of a limit on the amount of these credits granted each year should not be increased above the limits proposed in 2010 by the Commission. Indeed, if anything, that limit was too generous.

6. "Crony Capitalism" and "Dirigisme:" France has a form of government which is frequently derided as being socialistic, but in fact is a peculiar form of managed capitalism whereby the government directs its power to favor certain forms of economic activity. The term "dirigisme" is the French word for a "directed economic activity" approach which resembles capitalism, but depends upon the power of the government to make it work. Free market principles do not apply. Instead, various artificial monopolies and restraints on competition are imposed by the government in order to achieve what those in power perceive to be an overarching public good. This presumes, of course, that those within government are better able to determine how economic activities should proceed than those whose funds, efforts, and intelligence otherwise would determine success or failure in a free enterprise system.

"Crony Capitalism" is another version of directed capitalism.⁹ Instead of the State making conscious choices as to which economic activities will be favored, however, Crony Capitalism depends upon those elected officials who are most likely to be influenced by campaign contributions

⁹ Henderson, *The Economics and History of Cronyism*, Mercatus Center at George Mason University, (July, 2012).

having the power to cause government to favor the contributor. With Crony Capitalism comes the diversion of public funds to assist a particular industry, a particular taxpayer, or a particular interest group. The tendency of government to respond to powerful and generous political contributors is as old as the idea of government itself. However, it is also one of the seeds of the eventual destruction of the society that permits it. The "governmental entrepreneur" learns how to influence legislative power so as to divert public funds to accomplish a private benefit. Instead of providing a better good or service at a lower price, the public is offered average goods at an inflated price.

7. Sunsets and Automatic Reviews: In its 2010 report, the Commission recommended that all of Missouri's tax credit programs be subject to sunset provisions which would terminate those programs not expressly authorized to continue by new legislation. In the Commission's 2012 report, a majority of the members of the Commission were persuaded to vote in favor of removing a contrary recommendation contained in the 2010 report, i.e., the recommendation that all tax credit programs should be subject to a sunset. The reason given for this change was the fear that the existence of sunsets would mean that renewals of tax credit programs could be prevented by a filibuster. Of course, the filibuster device can be applied to prevent the enactment of any law necessary to improve justice and equity in Missouri. In other words, a filibuster can prevent the enactment of any needed and broadly supported legislation at any time, and not just with respect to previously authorized programs which require enabling legislation to continue. Giving in to this fear would mean that any program the state authorizes should never contain a sunset—regardless of how short the duration of the need—for fear that the program might need to be extended. The rules which allow a filibuster to thwart the legitimate needs of society should not be immutable, but are presumed to be so in the context of this discussion. Perhaps that is the initial error made in analyzing this issue, but that error is beyond the scope of the Commission's charge. An equally serious mistake, however, is the implicit presumption that all tax credit programs, once enacted, should not be subject to rigorous and regular reviews. Merely expressing that such a presumption should exist ought to be a sufficient rebuttal to it. Such a presumption means that carelessness and indifference to budgetary matters is an acceptable attitude for lawmakers. More to the point, Section 36 of Article III and Sections 23 and 28 of Article IV of Missouri's Constitution specify that appropriations can be made for no more than two fiscal years, i.e., "one general assembly cannot tie the hands of its successor."¹⁰ Ignoring sunsets for tax credit programs ignores this principle as well.

¹⁰ *State ex rel. Fath vs. Henderson*, 60 S.W. 1093 (Mo. 1901); *Kansas City Symphony vs. State*, 311 S.W.3d 272 (Mo. App. W.D. 2010).

D. **Conclusion:** The undersigned members of the Missouri Tax Credit Review Commission recognize that there may be political and practical difficulties in implementing some of the recommendations the Commission (and the undersigned) have made. Because of these difficulties, some members of the Commission suggested that the Commission's recommendations should be moderated to reflect political realities instead of principled ideals. The undersigned submit that such an approach compromises the value of an independent Commission's report. The undersigned recognize the difficulties the Legislative and Executive branches may face in their task of trying to incorporate these recommendations into new laws. However, we do not believe that you need our assistance in analyzing the political landscape. Instead, we believe that you require the best recommendations we can deliver, untainted by collateral or parochial considerations. If an ideal solution cannot be obtained, we hope that the effort to obtain that ideal will nevertheless ennoble those who strive to achieve it for the public's welfare.

We also hope that our efforts will be of assistance to you.

Respectfully Submitted,

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